U.S. Senate
Republican Policy Committee

Legislative Notice

Jon Kyl, Chairman

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H.R. 5970 – The Estate Tax and Extension of Tax Relief Act of 2006

Calendar No. 562

The House of Representatives passed H.R. 5970 on July 29, 2006, by a vote of 230 to 180; on July 31, 2006, it was read the second time and placed on the Senate Calendar.

Noteworthy

- It is expected that today, the Majority Leader will file a cloture petition on the motion to proceed to H.R. 5970. Accordingly, the Senate is expected to vote on the cloture motion on Friday, August 4, 2006.

- In 2001, Congress enacted a phase-out of the federal estate or "death" tax, with its complete repeal scheduled to occur in 2010. Due to Democrat opposition to the 2001 tax-relief bill in general, the repeal will only be temporary; the tax springs back to life in 2011 with a 55-percent top tax rate and only a $1 million exemption amount.

- H.R. 5970 provides a <u>permanent</u> reduction, but not full repeal, of the death tax.

- The bill increases the estate and gift tax exemption amount to $5 million per person. The $5 million exemption amount, indexed for inflation, will be fully phased in effective January 1, 2015.

- The bill provides that estates valued at between $5 million and $25 million, indexed for inflation, would be taxed at the capital gains rate, which is currently 15 percent, but set to increase to 20 percent in 2011, unless extended. The bill phases in a reduced tax rate on amounts in excess of $25 million, indexed for inflation, ultimately to 30 percent. This rate is not tied to the capital gains rate and will be fully effective January 1, 2015.

- The bill also extends through 2007 certain provisions of the tax code, such as the research and development credit, higher education expenses deduction, and the state and local sales tax deduction, which have expired or will soon expire.

- The bill increases the federal minimum wage from $5.15-per-hour to $7.25-per-hour incrementally over three years.

Background/Overview

Estate Tax: As part of the Economic Growth and Tax Relief Reconciliation Act of 2001, Congress enacted a phase-out of the federal estate, or "death" tax, with its complete repeal in 2010.[1] At the insistence of Senate Democrats, however, the application of the 2001 tax cuts was limited to 10 years.[2] As Figure 1 illustrates, the 10-year life of the statute produced a complex set of tax rules with respect to the death tax – rules that change *every year* until 2011.

Figure 1: Current Death Tax Law

Major Provisions of the Death Tax
2005 through 2011

Year	Individual Exemption Amount	Highest Tax Rate	Basis Rule
2005	$1.5 million	47 percent	Stepped-up basis at death*
2006	$2 million	46 percent	
2007		45 percent	
2008			
2009	$3.5 million		
2010	Death tax repealed	Death tax repealed	Stepped-up basis for up to $1.3 million of assets per person; carry-over basis for the balance of the estate**
2011 and later	$1 million	55 percent	Stepped-up basis at death*

*Under the stepped-up basis rule, the cost basis of an asset generally is increased to the fair market-value on the date of the decedent's death.
**Under the carry-over basis rule, the cost basis of an asset generally would be the price paid by the decedent when the asset was originally purchased.
Source: Internal Revenue Code

Tax Extenders: The FY 2006 budget resolution adopted by Congress (H. Con. Res. 95) authorized a revenue reconciliation bill that consists of changes in the laws within its jurisdiction sufficient to reduce revenues by not more than $11 billion for FY 2006 and not more than $70 billion for the period of FY 2006 through FY 2010.

[1] Title V of H.R. 1836, 107th Congress, 1st Session, Public Law 107-16, June 7, 2001.

[2] Section 901 of Public Law 107-16.

The Senate considered S. 2020 in November 2005 and approved the bill by a vote of 64 to 33 on November 18, 2005. Subsequently, the House of Representatives approved H.R. 4297, the Tax Relief Extension Reconciliation Act of 2005, by a vote of 234 to 197, on December 8, 2005. The Conference Committee approved the Conference Report on May 9, 2006. The Conference Report was adopted by the House of Representatives on May 10, 2006 by a vote of 244 to 185 and by the Senate by a vote of 54-44 on May 11, 2006. Many of the provisions that were not included in the final Conference Report are now included in H.R. 5970.

Bill Provisions

The following is a brief summary of the major provisions of H.R. 5970, The Estate Tax and Extension of Tax Relief Act of 2006:

Title I ─ Reform and Extension of Estate Tax after 2009

Reunification of the Estate, Gift and Generation Skipping Taxes. The bill reunifies the estate, gift and generation skipping taxes, establishing a common unified exemption amount and rate schedule. This ensures that gifts made during life are not given less favorable tax treatment than gifts made through a will.

Increased Estate and Gift Tax Exemption Amount. The bill gradually increases the exemption amount to $5 million per person. After reaching 2015, the amount will be indexed for inflation. The phased-in exemption increase beginning in 2010 is as follows:

- $3.75 million in 2010
- $4 million in 2011
- $4.25 million in 2012
- $4.5 million in 2013
- $4.75 million in 2014
- $5 million in 2015

Reduced Estate and Gift Tax Rates. The bill reduces the tax rate on the portion of the estate above the exclusion amount, but up to $25 million to the capital gains rate. Currently, the capital gains rate is 15 percent, but is set to increase to 20 percent in 2011 unless extended. For estates above $25 million, the bill phases in a reduced tax rate of 30 percent, not tied to capital gains rate, beginning in 2010 as follows:

- 40 percent in 2010
- 38 percent in 2011
- 36 percent in 2012
- 34 percent in 2013
- 32 percent in 2014
- 30 percent in 2015

In addition to indexing the $5 million amount, the bill also indexes the $25 million threshold amount for inflation after 2015.

Spouse Carryover. The bill allows a surviving spouse to carry over any unused portion of the exemption amount; the amount available to be carried over would be based on the exclusion amount for that year or alternatively on the inflation-adjusted amount if after 2015.

Stepped-Up Basis. The bill maintains the current stepped-up basis for property acquired from a decedent and repeals the modified carryover basis rules under EGTRRA that are set to take effect in 2010.

State Inheritance Taxes. The bill repeals, beginning in 2010, the deduction of state death taxes currently allowed to be taken when calculating the federal estate tax liability.

Figure 2: Summary of Estate Tax Rates Proposed in H.R. 5970

The following chart illustrates current law versus the provisions of H.R. 5970.

	Current Law		H.R. 5970		
				Tax Rate	
	Exemption	Subsequent Rate	Exemption	Amount up to $25 million	Amount Over $25 million
2006	$2.00 million	46 percent			
2007	$2.00 million	45 percent			
2008	$2.00 million	45 percent			
2009	$3.50 million	45 percent			
2010	Estate Tax Repealed		$3.75 million	15 percent[2]	40 percent
2011	$1.00 million	55 percent	$4.00 million	20 percent	38 percent
2012	$1.00 million	55 percent	$4.25 million	20 percent	36 percent
2013	$1.00 million	55 percent	$5.00 million	20 percent	34 percent
2014	$1.00 million	55 percent	$4.75 million	20 percent	32 percent
2015	$1.00 million	55 percent	$5.00 million	20 percent	30 percent
2016	$1.00 million	55 percent	$5.00 million[1]	20 percent	30 percent

Note: Under current law, carryover basis will replace stepped-up basis in 2010; under H.R. 5970, the step up is maintained
[1]Indexed for inflation beginning in 2016
[2]Tied to scheduled rate of capital gains tax
Source: Joint Committee on Taxation

Title II─ Extension and Expansion of Certain Tax Relief Bills:

Tuition Deduction. The 2001 tax act created a new above-the-line tax deduction for qualified higher education expenses (defined in the same manner as the HOPE credit) paid during tax years 2002 through 2005. The maximum deduction under the credit in 2005 was $4,000 for taxpayers with adjusted gross income (AGI) of $65,000 or less ($130,000 for married couples) or $2,000 for taxpayers with AGI of $80,000 or less ($160,000 for married couples). The bill extends the deduction through 2007.

New Markets Tax Credit (NMTC). The NMTC provides a tax credit to taxpayers who invest in businesses that are located in qualified low-income neighborhoods. The bill extends the NMTC for one year through 2008. In addition, the bill requires that the Secretary prescribe regulations to ensure that non-metropolitan counties receive a proportional allocation of qualified entity investments.

State and Local Sales Taxes. The American Jobs Creation Act provided that for tax years 2004 and 2005, a taxpayer may elect to take an itemized deduction for State and local general sales taxes in lieu of the itemized deduction permitted for State and local income taxes. Taxpayers were given two options for determining deductible sales tax: (i) actual sales tax paid if receipts are maintained for IRS verification or (ii) approximate sales tax paid as estimated in tables provided by the Secretary of the Treasury plus sales tax on certain additional items that may be added to the table amount. The provision extends the deduction through 2007.

Research and Development (R&D) Tax Credit. The bill extends the present-law research credit (which expired at the end of 2005) to qualified amounts paid or incurred during 2006 and 2007. The bill also increases the rates of the alternative incremental credit and adds a new alternative simplified credit that does not use gross receipts as a factor.

Work Opportunity Tax Credit (WOTC) and Welfare to Work (WTW). Employers may claim the WOTC if they hire individuals from groups that are considered to face barriers to employment. The bill extends both WOTC and WTW without modification through 2006. The provision extends the WTW credit through 2007 and combines it with the WOTC credit after 2006. Modifications of the combined credit include expanded eligibility for WOTC (raised age ceiling for food stamp recipients from 25 to 40), revised eligibility requirements for ex-felons (without regard to family income), and extended paperwork filing deadline from 21 days to 28 days. Employers may claim the WTW credit if they hire individuals who have received assistance for an extended period of time.

Combat Pay. Pursuant to the Working Families Tax Relief Act of 2004, combat pay (which is not otherwise taxable) may count as income for purposes of calculating the EITC. The provision is extended through 2007.

Qualified Zone Academy Bonds (QZABs). QZABs are tax credit bonds, which are issued by states and local governments to help repair schools, purchase school equipment and train teachers in economically distressed areas. The provision is extended through 2007. The bill also imposes a new requirement that the issuer reasonably expects to, and actually spends, 95 percent of the proceeds from the sale of QZABs on QZAB property within five years of the date of issuance. In addition, the bill imposes reporting requirements on the issuer.

Deduction for Teacher Classroom Expenses. In 2002, Congress began permitting elementary and secondary school teachers and certain other school professionals to deduct $250 for expenses paid or incurred for books, supplies, and other classroom equipment, regardless of whether the taxpayer itemizes his/her deductions. The provision is extended through 2007.

Brownfield Remediation Expensing. Taxpayers may expense costs incurred in the cleaning up of certain contaminated sites. The provision extends the expensing through 2007. In addition, the bill expands the definition of an eligible contamination site to include those contaminated by petroleum products.

Tax Incentives for Investment in the District of Columbia (D.C.). Certain economically distressed areas in D.C. are labeled "D.C. Enterprise Zone." The bill extends through 2007 four provisions that are intended to encourage redevelopment, capital investment, and homeownership in financially-distressed areas of the District: (1) designation of D.C. enterprise zone; employment tax credit; additional expensing; (2) tax-exempt D.C. empowerment zone bonds; (3) zero-percent capital gains rate for investment in D.C. property acquired by December 31, 2003 for gains through January 1, 2008; and (4) tax credit for first-time D.C. homebuyers.

Indian Employment Tax Credit. Employers receive a 20-percent tax credit on the first $20,000 of wages and employee health insurance costs paid to individuals who live on or near Indian reservations over the amount paid in 1993. Wages for which the work opportunity tax credit is available are not qualified wages for the Indian employment tax credit. The bill extends the credit through 2007.

Accelerated Depreciation for Business Property on Indian Reservations. A special depreciation recovery period applies to qualified Indian reservation property placed in service before January 1, 2006. In general, qualified Indian reservation property is property used predominantly in the active conduct of a trade or business within an Indian reservation, which is not used outside the reservation on a regular basis and was not acquired from a related person. The provision extends through 2007 for property that is used to conduct business on the reservation.

Fifteen-Year Depreciation for Leasehold Improvements. Current law reduces the depreciation period for leasehold improvements from 39 years, which is the general depreciation schedule, to 15 years. The provision is extended through 2007.

Fifteen-Year Depreciation for Restaurant Improvements and New Restaurant Properties. The bill extends a reduced 15-year depreciation period for restaurant improvements to existing restaurant properties through 2007, and also expands the bill to include new restaurant properties placed in service after the date of enactment of the bill and before the end of 2007.

Transfer or Rum Excise Taxes to Puerto Rico and the Virgin Islands. A $13.50 per proof gallon excise tax is imposed on distilled spirits produced in or imported (or brought) into the United States. The excise tax does not apply to distilled spirits that are exported from the United States, including exports to U.S. possessions. The Code provides for cover over (payment) to Puerto Rico and the Virgin Islands of the excise tax imposed on rum imported (or brought) into the United States, without regard to the country of origin. The amount of the cover over is limited to $10.50 per proof gallon ($13.25 per proof gallon during the period July 1, 1999 through December 31, 2005). The provision temporarily suspends the $10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the bill, the cover over amount of $13.25 per proof gallon is extended through 2007.

Excise Tax for Enforcing Mental Health Parity Rules. The bill extends the tax code, Employee Retirement Income Security Act (ERISA), and Public Health Service Act (PHSA) provisions relating to mental health parity to benefits for services furnished after the date of enactment and through 2007. Thus, the excise tax on failures to meet the requirements imposed by the tax code, ERISA, and PHSA provisions does not apply after December 31, 2005, and before the date of enactment.

Enhanced Deduction for Corporate Contributions of Scientific Property and Computer Equipment. Current law allows corporations to claim an enhanced tax deduction for certain donations of certain constructed or assembled scientific property and computer equipment. The provision with respect to donations of scientific property is permanent under the current law and the computer donations provision is extended through 2007.

Availability of Medical Savings Accounts. Within limits, contributions to an Archer medical savings account ("Archer MSA") are deductible in determining adjusted gross income if made by an eligible individual and are excludable from gross income and wages for employment tax purposes if made by the employer of an eligible individual. Earnings on amounts in an Archer MSA are not currently taxable. Distributions from an Archer MSA for medical expenses are not includible in gross income. Distributions not used for medical expenses are includible in gross income. The provision extends the availability of Archer MSAs through 2007.

Suspension of Limit on Percentage Depletion for Oil and Gas from Marginal Wells. Percentage depletion allows independent producers to deduct 15 percent of a marginal well's gross income each year, so long as the deduction does not exceed 100 percent of the well's net income in any year. The provision waives the 100-percent limitation through 2007.

Economic Development Credit for American Samoa. The bill provides a temporary, 2-year credit for assets by corporations operating in American Samoa. The credit is generally based on the amount of wages paid in American Samoa and depreciation deductions with respect to property located in American Samoa. The provision is effective for the first two taxable years beginning after December 31, 2005 and before January 1, 2008.

New York Liberty Zone Incentives for Transportation Infrastructure. The bill repeals several Liberty Zone incentives including special "bonus" depreciation, accelerated leasehold improvement recovery, extended replacement period for involuntary conversions and increased section 179 expensing. It provides tax credits, up to $1.75 billion for qualifying expenditures with respect to transportation infrastructure.

Gulf Opportunity Zone Bonus Depreciation. The bill modifies the bonus depreciation provisions contained in the Gulf Opportunity Zone Act of 2005 by extending the placed-in-service deadline for certain property used in highly damaged areas with the Gulf Opportunity Zone.

One-Year Extension of Authority for Undercover Operations. The bill extends through 2007 IRS authority to use the income earned by an undercover operation to pay additional expenses incurred in the undercover operation. Surpluses are required to be deposited into the General Fund and the IRS must conduct a detailed financial audit of such undercover operations and provide an annual audit report to Congress on all such undercover operations.

Authority for the IRS to Disclose Tax Information. Extends through 2007 IRS authority to disclose taxpayer identity information in order to: (1) facilitate combined employment tax reporting, (2) investigate terrorist activities, and (3) facilitate the repayment of student loans that are contingent on income.

Domestic Production Activities Deduction Expanded to Puerto Rico. The bill allows the U.S. businesses operating as branches in Puerto Rico to claim the domestic manufacturing deduction. The proposal is effective through 2007.

Incentive Stock Option AMT Proposal. The proposal allows taxpayers an expanded use of an individual's minimum tax credit (AMT refundable credit amount) of 20 percent per year (for the next five years). The AMT refundable credit amount is for long-term unused minimum tax credit – credits held over three years. The annual credit limit, subject to a phase-out, is the greater of (i) the lesser of $5,000 or the amount of the long-term unused AMT credit, or (ii) 20 percent of the amount of the long-term unused AMT credit.

Partial Expensing for Advanced Mine Safety Equipment. The bill provides increased expensing (instead of capitalizing such costs and depreciating them over a long period) for certain expenditures related to safety equipment for underground mines located in the United States. Fifty percent of the advanced mine safety equipment cost could be expensed in the year of purchase through 2008.

Mine Rescue Team Training Credit. The bill provides for a general business credit for training program costs of each qualified mine rescue team employee through 2008.

Whistleblower reforms. The bill provides permanent reform of the reward program for individuals who provide information regarding violations of the tax laws. The bill establishes a reward range from 15 percent to 30 percent of proceeds collected by IRS where the amount in dispute exceeds $2 million, subject to certain exceptions. The bill also creates a Whistleblower Office within the IRS within one year from the date of enactment to administer the reward program. The provision requires a yearly study and report by the Secretary of the Treasury.

Frivolous Submissions. The bill modifies the IRS-imposed penalty for frivolous submission of tax returns and other materials by increasing the amount of the penalty from $500 to $5,000 and by applying it to all taxpayers and to all types of Federal taxes. The increased penalty also applies to frivolous submissions for lien and levy collection due process, installment agreements, offers-in-compromise and taxpayer assistance orders.

Meningitis and HPV Vaccines. The bill permanently adds the meningococcal and human papillomavirus vaccines to the list of taxable vaccines in section 4132(a)(1) and is effective one month after date of enactment.

Make Permanent Certain Provisions Enacted in the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005. A number of provisions that were enacted on a temporary basis in TIPRA are now made permanent:

- Tax Treatment of Environmental Funds
- Simplification of the Active Trade or Business Test
- Veterans' Enhanced Access to Affordable Mortgages
- Tax Treatment of Self-Created Musical Works
- Modification of the Tonnage Tax
- Tax Treatment of the Permanent University Fund

Modification of Low-Income Mortgage Bonds for Veterans. The bill modifies the mortgage revenue bond program to provide one waiver of the first time homebuyer requirement for veterans who have served in active duty. The provision applies to mortgage revenue bonds issued before January 1, 2008.

Great Lakes Domestic Shipping. The bill permanently modifies the treatment of shipping within the Great Lakes to permit vessel operators in the region to qualify for the alternative tonnage tax regime. The provision is effective for taxable years beginning after date of enactment.

Sale of a Principal Residence by Certain Employees of the Intelligence Community. Under the bill, specified employees of the intelligence community may elect to suspend the running of the five-year test period during any period in which they are serving on extended duty. To qualify, a specified employee must move from one duty station to another and the new duty station must be located outside of the United States. As under present law, the five-year period may not be extended more than 10 years. The provision is effective for sales and exchanges after the date of enactment and before January 1, 2011.

Coke and Coke Gas Production Tax Credit. The Energy Act of 2005 provided a new tax credit for the production of coke to be used as a fuel. Coke is a fuel derived from coal typically used in the production of metallurgical steel or foundry metal. The new credit allows qualified facilities a 4- year credit beginning January 1, 2006 with a capacity cap per facility. The provision repeals the phase-out limitation and clarifies that qualifying facilities do not include the production of petroleum-based coke or coke gas.

Deferral of Capital Gains for Federal Judges Who Sell Property to Avoid Conflicts of Interest. The bill extends to Federal judges the ability, currently available to executive branch employees, to elect to defer capital gains on property sold to avoid conflicts of interest to the extent the proceeds are reinvested in other permitted property. The provision is effective for divestitures after date of enactment.

Premiums for Mortgage Insurance. The proposal establishes an itemized deduction for the cost of mortgage insurance on a qualified personal residence. The deduction is phased out ratably by 10 percent for each $1,000 by which the taxpayer's AGI exceeds $100,000. Thus, the deduction is unavailable for a taxpayer with an AGI in excess of $110,000. The provision is effective for amounts paid or accrued after December 31, 2006 and before January 1, 2008 for mortgage contracts issued after December 31, 2006.

Aviation Fuel. The bill permanently amends the Ultimate Vendor refund rules changed in the Highway Act. It would treat the aviation fuel purchaser of nontaxable noncommercial aviation fuel as the Ultimate Purchaser who would be allowed to file for a refund on his exempt fuel purchases. The refund claim would be quarterly.

Deduction for Qualified Timber Gain. The bill allows taxpayers to elect a new deduction equal to 60 percent of qualified timber gain, with the remaining 40 percent treated as ordinary income. Thus, for a corporation or individual in the 35-percent tax bracket, the effective tax rate on qualified timber gain would be reduced from 35 percent under present law to 14 percent under the proposal. The provision is effective for sales or exchanges made after date of enactment and through 2007.

Technical Correction Related to CFC-Look-Through Bill Enacted in TIPRA. The bill conforms the TIPRA look-through rule to its purpose of allowing U.S. companies to redeploy their active foreign earnings without an additional U.S. tax burden in appropriate circumstances. In order to qualify for this exception from Subpart F, a related party payment must not be attributable to income of the payor that is effectively connected with the conduct of a U.S. trade or business. The provision also clarifies Treasury's regulatory authority.

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Technical Correction Related to Interest Suspension Rules for Certain Listed Transactions, as Modified by the GO Zone Act. The bill clarifies that the Secretary of the Treasury may delegate his authority to permit interest suspension where taxpayers have acted reasonably and in good faith.

Title III: Modifications of the Abandoned Mine Land (AML) Program

Reauthorization of AML Program. The bill reauthorizes and modifies through 2021 the Abandoned Mine Land program. The program's funding would become mandatory, rather than discretionary as current law provides, and interest from the Abandoned Mine Land Trust Fund would go into three plans that provide health benefits to retired coal miners whose companies have gone out of business. The Treasury would be required to make payments into the health plans when needed, and the current annual $70 million cap on those payments would be eliminated.

Title IV: Minimum Wage

Increase Minimum Wage. The bill would increase the federal minimum wage over three years, from the current $5.15 per hour to $5.85 an hour on Jan. 1, 2007; $6.55 on June 1, 2008; and $7.25 on June 1, 2009.

Tip Credit. Currently, in the majority of states, tips received by tipped employees may be counted by employers to make up the difference between the $2.13 direct cash requirement and the minimum wage requirement. Seven states currently do not permit employers "tip credits," according to the Department of Labor: Alaska, California, Minnesota, Montana, Nevada, Oregon, and Washington. The bill would permit a tip credit in these states on this and future minimum wage increases.

Administration Position

A Statement of Administration Policy was not available at the time of publication.

Cost

The Joint Committee on Taxation (JCT) estimated that H.R. 5970 would result in a revenue loss of $52 billion over five years and $310 billion over 10 years. The estate tax provision alone would result in a $267 billion revenue loss over 10 years. For a copy of JCT's revenue estimate, please see http://www.house.gov/jct/x-34-06.pdf.